

**STATE OF CALIFORNIA
DEPARTMENT OF INSURANCE
45 Fremont Street, 22nd Floor
San Francisco, California 94105**

INITIAL STATEMENT OF REASONS

Date: November 1, 2002

RH02023676

**REGULATIONS FOR ENFORCEMENT ACTIONS AND
PENALTIES**

INTRODUCTION

Pursuant to Insurance Code section 12921.1, subdivision (a), paragraph (7), (the "Statute"), Insurance Commissioner Harry Low proposes to add to California Code of Regulations, Title 10, Chapter 5, Subchapter 3 the new Article 19, entitled "Regulations for Enforcement Actions and Penalties." The Statute requires that the commissioner establish a list of criteria for enforcement actions and guidelines for penalties. To the extent that these regulations will apply to enforcement actions concerning the Unfair Practices Act, they are also expressly authorized by Insurance Code section 790.10. Additionally, these regulations are authorized by *CalFarm v. Deukmejian* (1989) 48 Cal.3d 805, 825 [258 Cal.Rptr. 161] and *20th Century v. Garamendi* (1994) 8 Cal. 4th 216, 280 [32 Cal.Rptr.2d 807], which recognize the Commissioner's implied authority to exercise those powers that may fairly be implied from the statute granting the powers. The proposed regulations are intended to implement those statutory provisions that recognize the Commissioner's authority to enforce the Insurance Code. Specifically, the criteria will be used to determine which violations should be pursued through an enforcement action. The proposed regulations are also intended to implement those provisions of the Insurance Code which authorize the Commissioner to impose a penalty from within a specified range of penalties. Additionally, the Commissioner must promulgate appropriate guidelines to aid in determining the appropriate penalty for each violation based upon the nature, severity and frequency of the violation.

The Commissioner believes that the proposed regulations are necessary to carry out the requirement articulated in the Statute. These regulations are intended to provide greater uniformity in the enforcement process with respect to violations that adversely impact consumers and the insurance marketplace. The proposed regulations are reasonably necessary to achieve that end.

SPECIFIC PURPOSE AND REASONABLE NECESSITY OF REGULATION

The specific purpose of each adoption and the rationale for the Commissioner's determination that each adoption is reasonably necessary to carry out the purpose for which it is proposed are set forth below. Implementation of these regulations is necessary for efficient administration and enforcement of the Insurance Code, and to meet the statutory mandate.

SECTION 2591 PREAMBLE

This section specifies the authority under which the proposed regulations are promulgated. The Preamble sets forth the intent of the regulation, its authority, and its areas of application. The Preamble also provides that the proposed regulations will apply to enforcement actions pursuant to market conduct examinations and other investigations, in addition to enforcement actions pursuant to consumer complaints.

This section is necessary not only because it provides clarity and ease of reference, but also because limiting the regulations to violations discovered in the handling of consumer complaints but not market conduct exams would lead to significant enforcement inconsistencies since market conduct exams identify the same types of violations arising from similar transactions by the same entities. To create such an inconsistency would undermine the value and purpose of the proposed regulations.

SECTION 2591.1 SCOPE AND PURPOSE

This section specifies the scope and purpose of the proposed regulations. This section defines an "enforcement action" and lists the specific statutes to which these regulations are to apply. This section restricts the application of the proposed regulations to settlements and also harmonizes the regulations with other statutes or regulations that more specifically address particular violations.

The definition of enforcement action is not found in the Insurance Code and is necessary in order to restrict the application of the proposed regulations to those occasions involving evaluation of insurer acts or practices where deliberation and direction are necessary. It is reasonably necessary that the definition exclude lesser actions such as verbal warnings and warning letters so as not to hinder routine communications between the Department and its insurer licensees. By being limited to case settlements, the proposed regulations avoid being duplicative of or in conflict with the formal adjudication process. Rather, the proposed regulations provide needed uniformity by bringing structure to the broadened consideration of all factors relevant to each violation or illegal practice. At the same time, the regulations do not interfere with the insurer's alternative to seek a more formalized process with consideration of applicable statutory standards. By identifying those statutes which are relevant to both consumer complaints and market conduct examinations and which allow the commissioner discretion in the setting of penalties, this section provides clarity of application. This section is also reasonably necessary in order to avoid potential conflict with other provisions of law.

SECTION 2591.2

This section specifies the action that is necessary to initiate the enforcement process by directing the commissioner to the enforcement criteria and by detailing the two specific steps of the enforcement process. The first step is to consider the criteria in order to determine that an action is warranted. The second step is to consider the criteria in order to determine the appropriate penalty. This section also allows the Department to recover its costs associated with an enforcement action.

This section is necessary because it lays out the initial steps of the penalty process and compels the commissioner to take a consistent and reasoned approach to the penalty process that is consistent with the overall goal of the proposed regulations. The steps provided by the proposed regulations are necessary to meet requirements laid out in the Statute. The relevant penalty statutes provide no guidance as to when to initiate a penalty action or how to determine the appropriate amount of penalty from within the penalty ranges provided in the statutes. The recovery of costs is important so that the Department is not disadvantaged by taking the more efficient settlement approach rather than forcing an action into the formal hearing process, where costs may be recoverable. This section is therefore reasonably necessary in order to carry out the intent of the Statute that the Commissioner establish a program listing these criteria and guidelines.

SECTION 2591.3

This section provides the considerations which serve both as the “list of criteria to determine which violations should be pursued through enforcement act” and as the “guidelines that set forth appropriate penalties for violations based on the nature, severity, and frequency of the violations” specifically called for by the Statute. The criteria identified in the proposed regulations are the criteria historically used by the Department because of their relevance. This section is therefore reasonably necessary in order to carry out the intent of the Statute.

SECTION 2591.3, Subdivision (a)

The Statute calls for consideration of the “nature, severity, and frequency of the violations” which are under review for an enforcement action. This subdivision specifically provides for the consideration of severity and provides the necessary context for its consideration in the insurance transaction in question. Severity is not defined by statute. In this subdivision of the proposed regulations severity has been broken down into two components, detrimental impact and severity of impact. This definition allows consideration for both the harm and the egregiousness or degree of harm, arguably the most relevant considerations in the penalty process because they are the focus of the consumer complaint investigations and market conduct examinations, the major initiators of enforcement actions. Examples of the most common findings are provided for clarity.

SECTION 2591.3, Subdivision (b)

This subdivision specifically provides for the consideration of frequency, another statutorily mandated criterion, and provides the necessary context for evaluating frequency in terms of the number of insurance transactions that are investigated or examined by the Department and the number of persons impacted by the violations. The proposed regulations define frequency to include not only those violations which are specifically identified in the course of handling consumer complaints or conducting market conduct examinations, but also the number of violations which are reasonably determined to have taken place but which have not been specifically identified. This section is necessary because the Department reviews only a small percentage of the actual transactions conducted by insurers. It would be impractical to review every insurer transaction to specifically identify each violation; the Department needs reasonable flexibility to make appropriate determinations as to the number of violations resulting from insurer activities.

SECTION 2591.3, Subdivision (c)

This subdivision provides the first of the considerations which denote the “nature” of the violation. As the ultimate purpose of these regulations is to protect insurance consumers, knowledge and willfulness have been broadly defined in this subdivision. Broad definitions are reasonable because the proposed regulations apply to insurers, and it is reasonable to apply a high standard to insurers because they are charged with thorough knowledge of the provisions of the Insurance Code and with complying with those provisions. Insurers are also charged with communicating that knowledge to their employees and agents and with ensuring that their employees and agents act in accordance with the law. It is reasonable to have such broad definitions of knowledge and willfulness in the settlement context because it allows the parties to forgo the degree of investigation or discovery that might be necessary to prove a willful violation in a formal adjudication.

An enforcement action carries the dual purpose of penalizing those who have violated the law and serving as a deterrent for future noncompliance. Identifying an act or practice as willful typically doubles the amount of penalty that can be applied and thus creates a greater opportunity for the regulator to set a penalty that offsets or exceeds the monetary gains created by the noncompliance. It is important that noncompliance not be calculated to be a profitable venture because of the limited penalties applicable and the difficulty in proving a willful practice without an extensive investigatory undertaking (which can take place in market conduct examinations but would be extremely rare in the investigation of individual consumer complaints). Arguably, the entity who knowingly defies the law warrants a more severe penalty than those who violate the law unwittingly; in any event, penalizing those who violate the law willfully or knowingly sends a message to those who might consider similar noncompliance that the repercussions will be greater than the minimum or average penalties that might otherwise apply.

SECTION 2591.3, Subdivision (d)

This subsection identifies another consideration which is a component of the severity of the violation but also can be considered as another element of the nature of the violation — the overall gain or loss experienced by the insurer as a result of the violation. This consideration allows the Commissioner to take into account the monetary benefit to the insurer from a violation, such as would result from an overcharge of premium, a charge for an unwarranted fee, or an underpayment or delay of payment of a claim. Conversely, it also allows consideration for circumstances where there is a monetary loss experienced by the insurer — perhaps in an illegal effort to gain market share, provide preferred treatment to a given consumer, or retain business — any of which may ultimately provide a greater benefit to the insurer than the immediate monetary loss entails. Also, it is always the other customers who pay for it when one customer or group of customers is given an unsupported premium discount or claim overpayment. The most relevant reason to include such a criterion for consideration is to allow the commissioner the greatest leverage in having the penalty outweigh the benefit of a violation to the insurer.

SECTION 2591.3, Subdivision (e)

This subdivision provides another criterion for consideration that reflects an element of the frequency of the violations and also the nature of the violation. It provides parameters for the violations that will be under consideration in the evaluation process. The compliance record criterion allows consideration of the insurer's past non-compliant behavior as well as any mitigating corrective action taken by the insurer or the insurer's failure to take corrective action when indicated. Given that the language of the Statute makes clear that not every violation will be the subject of an enforcement action, this criterion provides the commissioner with the necessary flexibility to put the violation into context with the overall compliance behavior of the insurer, which is particularly necessary in determining whether an enforcement action is necessary to encourage future compliance by the insurer or whether the noncompliance was an aberration that, once corrected, is not likely to be repeated.

SECTION 2591.3, Subdivision (f)

This subdivision provides another criterion that reflects elements of both the frequency of the violations and the nature of the violation. The duration of the non-compliant activity may be reflective of the insurer's lack of quality control or attention to compliance and may be helpful as a determinant in distinguishing knowing or willful behavior from unintentional lapses in compliant behavior. It allows the commissioner to dismiss or lessen penalties for short-lived transgressions resulting from a minor oversight or a quickly corrected behavior. Again, this criterion provides the commissioner with the necessary flexibility to put the violation at hand in context with the overall behavior of the insurer with respect to compliance. The context of the violation is particularly important in determining whether an enforcement action is necessary in order to achieve future compliance by the insurer or whether the noncompliance was an aberration that, once corrected, is not likely to be repeated.

SECTION 2591.3, Subdivision (g)

This subdivision allows for consideration of a mitigating factor which may be used broadly to characterize the underlying nature of the violation. The inclusion of extraordinary circumstances as a consideration allows the commissioner to choose to refrain from an enforcement action or to lessen the amount of the penalty imposed irrespective of other criteria when the violation results in whole or in part from circumstances beyond the insurer's control. To the degree the violation is beyond the insurer's control, it is reasonable to provide the commissioner with the flexibility to recognize that an enforcement action may be an unwarranted punishment and meaningless as a deterrent against future noncompliance.

SECTION 2591.3, Subdivision (h)

This subdivision provides another criterion that allows consideration of the nature of the violation. The commissioner may take into account previous actions against insurers of similar size and circumstance. This criterion is consistent with the intended purpose of the regulations of creating greater consistency in the enforcement process but allows the necessary flexibility to escalate the penalty if previous penalties assessed for similar non-compliance are not producing the desired deterrent effect. This criterion also allows the commissioner to reevaluate the noncompliance and determine a penalty irrespective of previous penalty amounts.

SECTION 2591.4

This section provides the general framework and instructions for application of the criteria listed in section 2591.3. The criteria are designed for the Commissioner's use both for the decision as to whether to pursue an enforcement action and for the determination of an appropriate penalty in light of the violations found. The Commissioner may determine that the relevance of, or the weight to be accorded to, a criterion for purposes of deciding whether to pursue an enforcement action does not mirror the weight or the relevance assigned to that criterion for purposes of penalty assessment.

This section is reasonably necessary because it reinforces the principle that the evaluation of the criteria for purposes of the deciding whether to pursue an enforcement action is an operation separate and distinct from the evaluation of the criteria for purposes of deciding upon an appropriate penalty amount. More specifically, Section 2591.4 provides, among other things, that the amount of consideration given to a particular criterion when deciding whether or not to undertake an enforcement action may differ from the amount of consideration that same criterion is to receive when the penalty is decided upon. This provision is necessary in order to accommodate factual situations which implicate certain criteria more, or less, strongly for purposes of the decision as to whether an enforcement action is to be undertaken than for purposes of the decision as to the appropriate penalty. Similarly, Section 2591.4 leaves open the possibility that a criterion that is determined to be irrelevant in one of these decisions may nonetheless figure prominently in the other.

Additionally, it is necessary to provide that the Commissioner may consider criteria not listed in the proposed regulations. This section allows for the necessary flexibility to take into account any possible factual scenario that may be the subject of settlement negotiations. This provision, therefore, stresses that the listing of criteria is not all-inclusive. This section recognizes that flexibility is an important component in any settlement negotiation where the parties indicate a willingness to resolve an enforcement action prior to a full evidentiary hearing.

Thus, the Commissioner may consider criteria that are not listed in these regulations, when unique fact patterns warrant the consideration of such criteria. Settlement conditions, by definition, are voluntarily accepted by the affected insurer and the Department. The volitional component of settlement negotiations is enhanced when the parties are free to consider broad alternatives to a full evidentiary hearing. This section, therefore, provides the Commissioner with the necessary flexibility to ensure that enforcement actions culminating in a settlement agreement are resolved both equitably and efficiently

This section also ensures that the Commissioner's use of additional criteria will be transparent, by providing that when such additional criteria are considered, they will be discussed during the negotiation process.

IDENTIFICATION OF STUDIES

There are no specific studies relied upon in the adoption of this article.

SPECIFIC TECHNOLOGIES OR EQUIPMENT

Adoption of these regulations would not mandate the use of specific technologies or equipment.

ALTERNATIVES

The Commissioner has determined that no reasonable alternative exists to carry out the purpose for which the regulations are proposed. Performance standards were considered but were rejected as an unreasonable and impracticable alternative. Regulations specifying specific penalties for specific violations were also considered but were rejected because such an approach would be inflexible and not allow consideration for the multiple fact sets that surround a particular violation. For example, the failure to date stamp a particular document in a claim file, a violation of Title 10, Chapter 5, Subchapter 7.5, Section 2695.3(b)(2) of the Fair Claims Settlement Practices Regulations, may be a result of a simple clerical oversight or may have been a bad faith action by the insurer to obfuscate the insurer's knowledge of the document when a claim settlement offer is made, resulting in a lower offer than recognition of the information in the document would have justified. Regulations specifying set penalties would not provide the necessary flexibility to treat these two situations appropriately.

ECONOMIC IMPACT ON SMALL BUSINESS

The Commissioner does not foresee that the proposed regulations will have an economic impact on small business. The Commissioner has identified no reasonable alternatives to the presently proposed regulations, nor have any such alternatives otherwise been identified and brought to the attention of the Department, that would lessen any impact on small business